

**STATE OF CALIFORNIA  
DEPARTMENT OF INSURANCE  
45 Fremont Street, 24th Floor  
San Francisco, California 94105**

**INITIAL STATEMENT OF REASONS**

**Disability Income Insurance Benefit Reduction Regulations  
REG-2006-00009  
May 3, 2007**

**INTRODUCTION**

California Insurance Commissioner Steve Poizner proposes the adoption of a new article in the California Code of Regulations (“CCR”), Title 10, Chapter 5, Subchapter 2 Policy Forms and Other Documents, titled “Article 2.2. Limits on Benefit Reductions in Group Disability Income Insurance Policies” Sections 2232.45.1 (Authority and Purpose), 2232.45.2 (Benefit Reductions Shall Not Be Based on Involuntary Retirement), 2232.45.3 (Benefit Reductions Shall Not Be Based on Estimated Worker’s Compensation Temporary Disability Benefits Not Actually Received by the Insured), 2232.45.4 (Benefit Reductions Shall Not Be Based on Worker’s Compensation Permanent Disability), and 2232.45.5 (Benefit Reductions Based on Earnings Received for Work Performed While Disabled). Commissioner Poizner also proposes the adoption of amendments to the California Code of Regulations (“CCR”) Title 10, Chapter 5, Subchapter 3, Article 12, Disability Insurance Advertisements, Section 2536.2 (Advertisements of Benefits Payable, Losses Covered or Premiums Payable).

Commissioner Poizner proposes the adoption of a new Title 10, Chapter 5, Subchapter 2, Article 2.2 Limits on Benefit Reductions in Disability Income Insurance Policies, pursuant to the authority set forth below:

Section 2232.45.1: Authority cited: Section 790.10, Insurance Code. The Commissioner’s decision on the proposed regulation will implement, interpret, and make specific the provisions of Insurance Code section 790.03.

Section 2232.45.2: Authority cited: Section 790.10, Insurance Code. The Commissioner’s decision on the proposed regulation will implement, interpret, and make specific the provisions of Insurance Code section 790.03 and Kalvinskas v. California Institute of Technology (9<sup>th</sup> Cir. 1996) 96 F.3d 1305.

Section 2232.45.3: Authority cited: Section 790.10, Insurance Code. The Commissioner’s decision on the proposed regulation will implement, interpret, and make specific the provisions of Section 4903.1, Labor Code; Section 790.03, Insurance Code; and Silberg v. Cal. Life Ins. Co. (1974) 11 Cal. 3d 452.

Section 2232.45.4: Authority cited: Section 790.10, Insurance Code. The Commissioner’s decision on the proposed regulation will implement, interpret, and make specific the provisions of

Section 4903.1, Labor Code; Section 790.03, Insurance Code; and Russell v. Bankers Life Co. (1975) 46 Cal. App.3d 405.

Section 2232.45.5: Authority cited: Section 790.10. The Commissioner's decision on the proposed regulation will implement, interpret, and make specific the provisions of Section 790.03, Insurance Code; and Gruenberg v. Aetna Insurance Company (1973) 9 Cal.3d 566.

The Commissioner proposes the adoption of amendments to Title 10, Chapter 5, Subchapter 3, Article 12, Disability Insurance Advertisements, section 2536.2, pursuant to the authority vested in him by sections 790.10 of the California Insurance Code. The Commissioner's decision on the proposed amendments will implement, interpret, and make specific the provisions of Section 790.03, Insurance Code.

## **DESCRIPTION OF THE PUBLIC PROBLEM**

### **Introduction**

Disability income insurance policies are "designed to provide a substitute for earnings when, because of bodily injury or disease, the insured is deprived of the capacity to earn his living." Erreca v. Western States Life Insurance Co. (1942) 19 Cal.2d 388, 397. These policies pay benefits equal to a specified percentage of the insured's lost earnings. Typically, for insureds who have not retired, these policies provide that the maximum benefit amount payable to the insured shall be reduced by the amounts of other payments received by the insured for his or her disability. These benefit reductions, commonly known as "offsets," prevent the insured from receiving a double recovery – recovering more money while disabled than while working – and thereby encourage the insured to return to work, if possible. For example, if a policy provides for a maximum benefit amount of 60% of the insured's salary, this amount may be reduced by the amount of Social Security disability benefits and state disability income benefits the insured also receives.

### **Benefit Reductions Based on Estimated Retirement Amounts**

Problems have arisen when insurers want to estimate and deduct from the maximum benefit amount the amount of retirement benefits the insured would receive if the insured retired, even though the insured has not retired, is therefore not eligible for retirement benefits, and is not receiving those benefits. This practice has been held to be a form of age discrimination because it constitutes "forced retirement." When these amounts are deducted from the insured's benefit amount the insured often has no financial choice other than to retire, so that he or she can become eligible to receive the retirement benefits that the insurer is already deducting from the benefit amount under the disability income insurance policy. The proposed regulations prohibit insurers from estimating and deducting from the maximum benefit amount the amount of retirement benefit the insured would receive if the insured chose to retire. The Commissioner has determined that proposed section 2232.45.2 is reasonably necessary to ensure that insurers do not use reductions for estimated retirement benefits in a manner that will force insureds to retire.

### **Benefit Reductions Based on Worker's Compensation Benefits**

In other instances, some group disability insurers seek to estimate and deduct from the maximum benefit amount an amount for worker's compensation temporary disability benefits even though the benefits have not been received by the insured. The practice of reducing the maximum benefit

amount for estimated worker's compensation temporary disability benefits not received by the insured is objectionable because it violates the insurer's duty of good faith towards the insured; it can cause great financial hardship to the insured, who then receives neither temporary worker's compensation benefits nor benefits under his or her disability insurance policy; and it circumvents California's existing statutory scheme for worker's compensation, which allows the insurer to place a lien on benefits in the insured's worker's compensation claim proceeding. Similarly, some group disability income insurers wish to reduce maximum benefit amounts by the amount of the insured's worker's compensation permanent disability benefits. This practice is also objectionable, because California courts have held that, unlike worker's compensation temporary disability benefits, which are designed to replace lost wages, worker's compensation permanent disability benefits are not based solely on loss of wages, but are designed to compensate the insured employee for permanent bodily impairment and for the resulting impairment of future earning capacity. Russell v. Banker's Life Co. (1975) 46 Cal. App.3d 405, 415-416. The proposed regulations address both of these issues by (1) prohibiting insurers from estimating and deducting for worker's compensation temporary disability benefits that have not been received by the insured (proposed section 2232.45.3), and (2) prohibiting insurers from deducting the insured's worker's compensation permanent disability benefits from benefits payable under the disability income insurance policy (proposed section 2232.45.4). The proposed regulations are reasonably necessary to achieve these purposes.

#### Benefit Reductions Based on Earnings While Disabled

Some group disability income insurers have reduced the insured's maximum benefit amount by an amount that they estimate is equal to the earnings that the insured will receive for work performed while the insured is disabled. These estimates, if they are made at all, should not be based on speculation or unfounded projections of the earnings a disabled insured might be able to earn at some time in the future. At minimum, these estimates should be grounded upon a good faith reasonable calculation of projected earnings. Proposed regulation section 2232.45.5 sets forth this standard. The Commissioner has determined that section 2232.45.5 is reasonably necessary to help ensure that, if these kinds of estimates are to be made, that they comply with standards of good faith and fair dealing.

#### Inadequate Disclosure of Benefit Reductions

Finally, problems arise when the purchasers of such policies or the persons insured by such policies are unaware, at the time the policy is purchased, that the insured will not receive the maximum benefit amount stated in the policy marketing materials if the benefit reductions in the policy apply. Insureds sometimes do not discover that benefit reductions apply to their maximum benefit amount, or they do not understand the impact of such benefit reductions, until after they have become totally disabled and request payment of benefits under their policy. Insureds who believe they have paid premiums in order to receive 60% of their pre-disability salary from their insurer may find, for example, that they are instead receiving a fraction of that amount from the insurer due to the application of the benefit reductions in the policy. This problem highlights the need for greater disclosure of benefit reductions in marketing materials. The Commissioner has determined that all group disability income insurers should be subject to uniform requirements in this regard to ensure that no insurer is unfairly disadvantaged. Uniform disclosure requirements also aid purchasers of group coverage, who will be supplied with information about benefit reductions in a clear, understandable manner. The purpose of the proposed amendments to section 2536.2 is to set forth

such requirements. The Commissioner has determined that the amendments are reasonably necessary to carry out this purpose.

The overall objectives of the proposed regulations are to require better disclosure of benefit reductions so that policyholders and insureds more fully understand the coverage they are purchasing, to prevent benefit reductions which are inconsistent with existing law, and to help ensure that benefit reductions for estimated earnings meet the standard for good faith and fair dealing.

### **SPECIFIC PURPOSE AND REASONABLE NECESSITY FOR REGULATIONS:**

The specific purpose of each regulation and the rationale for the Commissioner's determination that each regulation is reasonably necessary to carry out the purpose for which it is proposed is set forth below.

#### **Addition of New Article 2.2**

California Code of Regulations Title 10, Chapter 5, Subchapter 2, titled "Policy Forms and Other Documents," contains regulations which govern the filing and contents of certain forms required to be filed with the Department of Insurance. The Commissioner proposes to add a new article to Subchapter 2, titled "Article 2.2. Limits on Benefit Reductions in Disability Income Insurance Policies," which contains the following regulation sections:

**Section 2232.45.1. Authority and Purpose.** Existing law does not set forth the legal authority and the purpose of the proposed regulations in this Article. This section does so. The purpose of this section is to make the authority for the regulations and the purpose for them clear. Section 2232.45.1 is reasonably necessary to carry out this purpose.

#### **Section 2232.45.2. Benefit Reductions Shall Not Be Based on Involuntary Retirement.**

Insurance Code section 790.03 defines "unfair methods of competition and unfair and deceptive acts or practices in the business of insurance." These practices include "Making, issuing, circulating, or causing to be made, issued or circulated, any estimate, illustration, circular, or statement misrepresenting the terms of any policy issued or to be issued or the benefits or advantages promised thereby..." (Insurance Code section 790.03(a)) and "Making or disseminating or causing to be made or disseminated before the public in this state, in any newspaper or other publication, or any advertising device, or by public outcry or proclamation, or in any other manner or means whatsoever, any statement containing any assertion, representation or statement with respect to the business of insurance ... which is untrue, deceptive, or misleading, and which is known, or which by the exercise of reasonable care should be known, to be untrue, deceptive, or misleading." (Insurance Code section 790.03(b)). Insurance Code section 790.10, titled "Rules and Regulations," gives the Commissioner express authority to promulgate reasonable rules and regulations as are necessary to administer Article 6.5, Unfair Practices, of which section 790.03 is a part.

Existing law also includes the Kalvinskas decision (Kalvinskas v. California Institute of Technology (1996) 96 F.3d 1305). In Kalvinskas, the United States Court of Appeals for the Ninth Circuit held

that it was unlawful for the California Institute of Technology to reduce an employee's disability benefits by the amount of benefits that he could only receive by retiring, when the employee was not eligible for such benefits because he had not chosen to retire.

The purpose of section 2232.45.2 is to implement, interpret, and make specific the more general statutory requirements of Insurance Code section 790.03(a) and (b) in a manner that is consistent with the Kalvinskas court decision. It would be untrue, deceptive, and misleading for a policy of group disability income insurance to provide that the insurer may estimate and deduct for retirement benefits regardless of whether the insured has chosen to retire, when such a provision would be inconsistent with and unenforceable under the holding of the Kalvinskas case. Proposed section 2232.45.2 provides that a policy of disability income insurance shall not contain any provision that permits the insurer to estimate and deduct for certain specified retirement benefits if the insured has not voluntarily retired. This regulation is reasonably necessary to prohibit policy provisions that would be untrue, deceptive, and misleading because they are inconsistent with existing law.

**Section 2232.45.3. Benefit Reductions Shall Not Be Based on Estimated Worker's Compensation Temporary Disability Benefits Not Actually Received by the Insured.**

Insurance Code section 790.03 subsections (a) and (b), set forth above, prohibit policy provisions which are misrepresentations, and prohibit statements with respect to the business of insurance which are untrue, deceptive, or misleading. Insurance Code section 790.10 expressly grants the Commissioner rulemaking authority to implement, interpret, and make these sections more specific.

In Silberg v. California Life Insurance Company (1974) 11 Cal.3d 452, the defendant insurer failed to pay benefits under a hospital and medical insurance policy while the insured's worker's compensation claim was pending. As a result, the injured insured became destitute and unable to pay for medical care. The Supreme Court of California held that "the defendant's failure to afford relief to its insured against the very eventuality insured against by the policy amounts to a violation as a matter of law of its duty of good faith and fair dealing implied in every policy." Silberg, 11 Cal. 3d 452 at 462. The Court stated that had the insurer paid benefits under the policy and it was ultimately determined that worker's compensation covered the injury, "defendant could have asserted a lien in the workmen's compensation proceeding to recover the payments it had made and it would have been entitled to payment from the proceeds of the [worker's compensation] award. (citations omitted)"

California Labor Code section 4903.1 provides that before a worker's compensation award is issued or compromise of claim is approved, it shall be determined "whether any benefits have been paid or services provided by a health care provider, a health care service plan, a group disability policy, including a loss of income policy, a self-insured employee welfare benefit plan, or a hospital service contract, and its award or approval shall provide for reimbursement for benefits paid or services provided under these plans as follows...." Under the Labor Code, a claim for reimbursement for payment of benefits under a group disability income insurance policy is treated the same way as a claim for reimbursement for payment of hospital and medical expenses: the insurer files a lien in the worker's compensation proceeding.

It would be a misrepresentation for a policy to allow the insurer to estimate and deduct for worker's

compensation temporary disability benefits not actually received by the insured, because such a provision would be contrary to the holding in Silberg. Such a provision also would be untrue, deceptive, and misleading. The purpose of proposed section 2232.45.3 is to implement, interpret, and make Insurance Code section 790.03 specific by prohibiting provisions in a policy that allow the insurer to estimate and deduct for worker's compensation temporary disability benefits not actually received by the insured. The Commissioner has determined that this section is reasonably necessary to carry out this purpose.

#### **Section 2232.45.4. Benefit Reductions Shall Not Be Based on Estimated Worker's Compensation Permanent Disability.**

As described above, Insurance Code section 790.03 subsections (a) and (b) prohibit policy provisions which are misrepresentations, and prohibit statements with respect to the business of insurance which are untrue, deceptive, or misleading. Insurance Code section 790.10 expressly grants the Commissioner rulemaking authority to implement, interpret, and make these sections more specific.

In Russell v. Bankers Life Co. (1975) 46 Cal. App.3d 405, the court held that the insurer could offset the amount of worker's compensation temporary disability benefits, but not the amount of worker's compensation permanent disability benefits. California courts have held that, unlike worker's compensation temporary disability benefits, which are designed to replace lost wages, worker's compensation permanent disability benefits are not based solely on loss of wages, but are designed to compensate the insured employee for permanent bodily impairment and for the resulting impairment of future earning capacity. Russell v. Banker's Life Co. (1975) 46 Cal. App.3d 405, 415-416. The Labor Code reflects this distinction. California Labor Code section 4903.1(a)(3) permits a lien against temporary disability indemnity for payments made under a group disability income insurance policy, but the lien "shall not exceed the award for temporary disability indemnity." This means that the insurer may not assert a lien against worker's compensation permanent disability benefits for payments made under a group disability income insurance policy.

The purpose of proposed section 2232.45.4 is to implement, interpret, and make Insurance Code section 790.03 subsections (a) and (b) specific by providing that a policy of group disability income insurance shall not contain any provision that permits the insurer to reduce benefits by deducting for worker's compensation permanent disability benefits. Section 2232.45.4 is reasonably necessary to carry out this purpose.

#### **Section 2232.45.5. Benefit Reductions Based on Earnings Received for Work Performed While Disabled.**

As described above, Insurance Code section 790.03 subsections (a) and (b) prohibit policy provisions which are misrepresentations, and prohibit statements with respect to the business of insurance which are untrue, deceptive, or misleading. Insurance Code section 790.10 expressly grants the Commissioner rulemaking authority to implement, interpret, and make these sections more specific.

Existing law states that insurers have a duty "to act in good faith and fairly in handling the claim of an insured, namely a duty not to withhold unreasonably payments due under a policy." Gruenberg v.

Aetna Insurance Co. (1973) 9 Cal.3d 566 at 573. The purpose of proposed section 2232.45.5 is to set forth this duty and make it specific as it applies to group disability income insurance policies by providing that an insurer shall not estimate and deduct for earnings received by the insured for work performed while the insured is disabled unless there is a good faith reasonable basis for its calculation of the amount of estimated earnings. Proposed section 2232.45.5 is reasonably necessary to clarify the application of this standard and to ensure that it is applied to estimates of earnings under group disability income insurance policies.

#### Amendment of Existing 10 CCR Section 2536.2

#### **Section 2536.2. Advertisements of Benefits Payable, Losses Covered or Premiums Payable.**

Existing law, 10 CCR section 2536.2, contains very specific requirements and prohibitions applicable to insurance advertisements. The purpose of Title 10, Chapter 5, Subchapter 3, Article 12, of which section 2536.2 is a part, is “to assure truthful and adequate disclosure of all material and relevant information in the advertising of disability insurance.” 10 CCR section 2535.1. However, the existing law does not contain specific requirements for the disclosure of benefit reductions such as offsets.

The purpose of the proposed amendments to 10 CCR section 2536.2 is to set forth specific requirements for the disclosure of benefit reductions in advertisements for group disability income insurance. Under the amendments, insurers must describe each such reduction and the circumstances under which the reduction would apply. The advertisement must contain an example of how the reductions would reduce the amount of the benefit the insured would receive. The proposed amendments require that this information be placed in the part of the advertisement in which the maximum benefit amount is described, and that it be given the same prominence as the maximum benefit amount.

If purchasers of this coverage have a better understanding of the extent to which benefits can be reduced, they may make better purchasing decisions. They may decide to purchase less coverage, more coverage, or different coverage, but in any event their purchasing decision will be aided by the disclosure of more information about the product they are purchasing. They will have a better idea of how the amount of premium that is paid relates to the amount of benefits the insured may actually receive from the disability income insurer if the insured becomes totally disabled. The amendment is reasonably necessary to achieve this purpose.

#### SPECIFIC TECHNOLOGIES OR EQUIPMENT

Adoption of these regulations would not mandate the use of specific technologies or equipment.

#### IDENTIFICATION OF STUDIES

There are no technical, theoretical, and empirical studies, or similar documents relied upon in proposing the adoption of the regulations.

## REASONABLE ALTERNATIVES TO THE REGULATIONS; IMPACT ON SMALL BUSINESS

The Commissioner has identified no reasonable alternatives to the presently proposed regulations, nor have any such alternatives otherwise been identified and brought to the attention of the Department of Insurance, that would carry out the purpose for which the regulations are proposed or which would lessen any impact on small business. Indeed, the proposed regulations are not anticipated to affect small business. Although performance standards were considered as an alternative, they were rejected as ineffective in addressing the problems described above involving benefit reductions in group disability income insurance policies.

## ECONOMIC IMPACT ON BUSINESSES AND THE ABILITY OF CALIFORNIA BUSINESSES TO COMPETE:

The Commissioner has made an initial determination that adoption of the proposed regulations may have a significant, statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states. The types of businesses that may be affected are insurance companies. To the extent the regulations clarify that certain benefit reduction provisions in group disability income forms that are subject to review and approval in California are prohibited, companies subject to these requirements may or may not lose business to out-of-state disability insurers whose group forms are issued or delivered out-of-state and are not subject to California's filing requirements. There should not be an economic impact as a result of the regulations prohibiting certain benefit reductions because under existing law insurers should not be making these kinds of benefit reductions. Insurance companies authorized to transact disability insurance in California may incur some costs as a result of changing their advertisements to provide the disclosures required by proposed section 2536.2. Proposed section 2232.45.5, concerning insurers' duty of good faith and fair dealing, should not have a financial impact because insurers are already subject to this standard. The Commissioner has considered performance standards, but the Commissioner has identified no performance standards that would be as effective as the proposed regulations in enforcing the statutes that form the basis for the proposed regulations. The Commissioner has not considered other proposed alternatives that would lessen any adverse economic impact on business and invites interested parties to submit proposals. Submissions may include the following considerations:

- (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to businesses;
- (ii) Consolidation or simplification of compliance and reporting requirements for businesses;
- (iii) The use of performance standards rather than prescriptive standards;
- (iv) Exemption or partial exemption from the regulatory requirements for businesses.

## PRENOTICE DISCUSSIONS

Pursuant to Government Code section 11346.45 the Commissioner conducted a prenotice public discussion concerning proposed regulations governing benefit reductions on October 30, 2006. Notice of the prenotice public discussion was provided to all those who have requested notice of regulatory proceedings conducted by the Commissioner concerning the subject matter of the regulations. The Commissioner received written and oral comments at the public discussion.